Chapter 25: The Basics of Credit

I-Summary: This chapter explains credit, how interest works, and identifies where you can get credit. A creditor lends money to a borrower, who is also called the debtor. The fee creditors charge for using their money is called interest. The amount of interest paid on a loan depends on the interest rate, the length of time of the load, and the amount of the loan. People use consumer credit for personal reasons, businesses use commercial credit for business reasons. The government uses credit to pay for services and programs it provides to citizens. Using credit is convenient, and enables people to get the use of goods and services without having to wait until they have saved for them. Using credit enables people to establish a good credit rating, which enables them to get more credit more easily. The use of credit contributes to the growth of our economy. Credit is easy to misuse, and debtors must keep in mind that they have committed future earnings when they use credit. Before deciding to use credit, consider if you can afford the item, want to use savings instead, have the cash for a down payment, or might use the credit in a better way. Look carefully at the cost of using credit. Credit is available through store charge accounts, various types of credit cards, and loans from financial institutions. Installment loans for such items as cars and mortgage loans for real estate often require collateral, which is something of value the bank can take if the borrower does not make the required loan payments. Payday advance services and pawnshop loans typically charge high fees.

I-Quiz

Quiz yourself to check your understanding. For each question, you will hear four answer choices. After you hear all four answer choices, choose your answer during the pause. Then you will hear the correct answer. Let’s begin.

Question 1

Which describes the relationship between credit, or the amount borrowed, and the interest paid on a loan?

a. The larger the amount borrowed, the lower the interest rate.

b. Credit is a percentage of the interest paid on a loan.

c. Interest payments earn credit.

d. Interest is a percentage of the amount borrowed.

Question 2

Which is true about credit in the United States?

a. The use of credit is limited to consumers and businesses.

b. The use of credit is uncommon in our society.

c. Federal, state, and local governments use credit to finance public works.

d. The use of credit slows the growth of the economy.

Question 3

Which is NOT a typical source of consumer credit?

a. state government

b. bank loans

c. credit card companies

d. store charge accounts

Question 4

What is collateral?

a. a type of installment loan

b. another word for interest

c. something of value that can be used to repay a loan

d. credit provided by the seller to the consumer

Question 5

Which type of loan might be an option for someone with a bad credit rating?

a. pawnshop loan

b. single-payment loan

c. mortgage loan

d. commercial credit

Answer Key

1. The correct answer is D, Interest is a percentage of the amount borrowed. Interest is like a fee you pay for the use of someone else's money.

2. The correct answer is C, Federal, state, and local governments use credit to finance public works. The building of parks, bridges, highways, and government office buildings are often financed by governments using credit.

3. The correct answer is A, state government. Although they may regulate the use of credit through such things as usury laws, states are not in the business of offering credit to consumers.

4. The correct answer is C, something of value that can be used to repay a loan. When you purchase a home using a mortgage loan, the home serves as collateral. If you cannot make the mortgage payments, the mortgage company can take the home and sell it.

5. The correct answer is A, pawnshop loan. A pawnshop loan is based on the value of something you own that is left with a pawnbroker as security against money you have borrowed.